(B) All partnership cash flow (determined prior to consideration of the guaranteed payment) will be distributed 75 percent to C and 25 percent to D except that guaranteed payments that the partnership is obligated to make to C are payable solely out of D's share of the partnership's cash flow.

(ii) If D's share of the partnership's cash flow is not sufficient to make the guaranteed payment to C, then D is obligated to contribute any shortfall to the partnership, even in the event the partnership is liquidated. Thus, the effect of the guaranteed payment arrangement is that the guaranteed payment to C is funded entirely by D. The partnership agreement complies with the requirements of §1.704–1(b)(2)(ii)(*b*). Assume that, at the time the partnership is formed, the partnership or D could borrow $25,000 pursuant to a loan requiring equal payments of principal and interest over a four-year term at the current market interest rate of approximately 12 percent (compounded annually). Assume that the highest applicable Federal rate in effect at the time the partnership is formed is 10 percent compounded annually.

(iii) The transfer of money to be made to C under the partnership agreement is characterized by the parties as a guaranteed payment for capital and is determined without regard to the income of the partnership. The transfer is also reasonable within the meaning of §1.707–4(a)(3). The transfer, therefore, is presumed to be a guaranteed payment for capital. The presumption set forth in §1.707–3(c) (relating to transfers made within two years of each other) thus does not apply to this transfer. The transfer will not be treated as part of a sale of property to the partnership unless the facts and circumstances clearly establish that the transfer is not a guaranteed payment for capital and is part of a sale.

(iv) For the first four years of partnership operations, the total guaranteed payments made to C under the partnership agreement will equal $33,332. If the characterization of those payments as guaranteed payments for capital within the meaning of section 707(c) were respected, C would be allocated $24,999 of the deductions that would be claimed by the partnership for those payments, thereby leaving the balance in C's capital account approximately $25,000 less than it would have been if the guaranteed payments had not been made. The guaranteed payments thus have the effect of offsetting approximately $25,000 of the credit made to C's capital account for the property transferred to the partnership by C. C's resulting capital account is approximately equivalent to the capital account C would have had if C had only contributed 75 percent of the property to the partnership. Furthermore, the effect of D's funding the guaranteed payment to C (either through reduced distributions of cash flow to D or additional contributions) is that D's capital account is approximately equivalent to the capital account D would have had if D had contributed 25 percent of the property (or contributed cash so that the partnership could purchase the 25 percent). Moreover, a $25,000 loan requiring equal payments of principal and interest over a four-year term at the current market interest rate of 12 percent (compounded annually), would have resulted in annual payments of principal and interest of $8,230.86. Consequently, the guaranteed payments effectively place the partners in the same economic position that they would have been in had D purchased a one-quarter interest in the property from C financed at the current market rate of interest, and then C and D each contributed their share of the property to the partnership. In view of the burden the guaranteed payments place on D's right to transfers of partnership cash flow and D's legal obligation to make contributions to the partnership to the extent necessary to fund the guaranteed payments, D has effectively purchased through the partnership a one-quarter interest in the property from C.

(v) Under these facts, the presumption that the transfers to C are guaranteed payments for capital is rebutted, because the facts and circumstances clearly establish that the transfers are part of a sale and not guaranteed payments for capital. Under §1.707–3(a), C and the partnership are treated as if C sold a one-quarter interest in the property to the partnership in exchange for a promissory note evidencing the partnership's obligation to make the guaranteed payments.

(b) *Presumption regarding operating cash flow distributions*—(1) *In general.* Notwithstanding the presumption set forth in §1.707–3(c) (relating to transfers made within two years of each other), an operating cash flow distribution is presumed not to be part of a sale of property to the partnership unless the facts and circumstances clearly establish that the transfer is part of a sale.

(2) *Operating cash flow distributions*—(i) *In general.* One or more transfers of money by the partnership to a partner during a taxable year of the partnership are operating cash flow distributions for purposes of paragraph (b)(1) of this section to the extent that those transfers are not presumed to be guaranteed payments for capital under paragraph (a)(1)(ii) of this section, are not reasonable preferred returns within the meaning of paragraph (a)(3) of this section, are not characterized by the parties as distributions to the partner acting in a capacity other than as a

partner, and to the extent they do not exceed the product of the net cash flow of the partnership from operations for the year multiplied by the lesser of the partner's percentage interest in overall partnership profits for that year or the partner's percentage interest in overall partnership profits for the life of the partnership. For purposes of the preceding sentence, the net cash flow of the partnership from operations for a taxable year is an amount equal to the taxable income or loss of the partnership arising in the ordinary course of the partnership's business and investment activities, increased by tax exempt interest, depreciation, amortization, cost recovery allowances and other noncash charges deducted in determining such taxable income and decreased by—

(A) Principal payments made on any partnership indebtedness;

(B) Property replacement or contingency reserves actually established by the partnership;

(C) Capital expenditures when made other than from reserves or from borrowings the proceeds of which are not included in operating cash flow; and

(D) Any other cash expenditures (including preferred returns) not deducted in determining such taxable income or loss.

(ii) *Operating cash flow safe harbor.* For any taxable year, in determining a partner's operating cash flow distributions for the year, the partner may use the partner's smallest percentage interest under the terms of the partnership agreement in any material item of partnership income or gain that may be realized by the partnership in the three-year period beginning with such taxable year. This provision is merely intended to provide taxpayers with a safe harbor and is not intended to preclude a taxpayer from using a different percentage under the rules of paragraph (b)(2)(i) of this section.

(iii) *Tiered partnerships.* In the case of tiered partnerships, the upper-tier partnership must take into account its share of the net cash flow from operations of the lower-tier partnership applying principles similar to those described in paragraph (b)(2)(i) of this section, so that the amount of the upper-tier partnership's operating cash flow distributions is neither overstated nor understated.

(c) *Accumulation of guaranteed payments, preferred returns, and operating cash flow distributions.* Guaranteed payments for capital, preferred returns, and operating cash flow distributions presumed not to be part of a sale under the rules of paragraphs (a) and (b) of this section do not lose the benefit of the presumption by reason of being retained for distribution in a later year.

(d) *Exception for reimbursements of preformation expenditures.* A transfer of money or other consideration by the partnership to a partner is not treated as part of a sale of property by the partner to the partnership under §1.707–3(a) (relating to treatment of transfers as a sale) to the extent that the transfer to the partner by the partnership is made to reimburse the partner for, and does not exceed the amount of, capital expenditures that—

(1) Are incurred during the two-year period preceding the transfer by the partner to the partnership; and

(2) Are incurred by the partner with respect to—

(i) Partnership organization and syndication costs described in section 709; or

(ii) Property contributed to the partnership by the partner, but only to the extent the reimbursed capital expenditures do not exceed 20 percent of the fair market value of such property at the time of the contribution. However, the 20 percent of fair market value limitation of this paragraph (d)(2)(ii) does not apply if the fair market value of the contributed property does not exceed 120 percent of the partner's adjusted basis in the contributed property at the time of contribution.

(e) *Other exceptions.* The Commissioner may provide by guidance published in the Internal Revenue Bulletin that other payments or transfers to a partner are not treated as part of a sale for purposes of section 707(a)(2) and the regulations thereunder.

[T.D. 8439, 57 FR 44981, Sept. 30, 1992; 57 FR 56444, Nov. 30, 1992]

§ 1.707–5 Disguised sales of property to partnership; special rules relating to liabilities.

(a) *Liability assumed or taken subject to by partnership*—(1) *In general.* For purposes of this section and §§ 1.707–3 and 1.707–4, if a partnership assumes or takes property subject to a qualified liability (as defined in paragraph (a)(6) of this section) of a partner, the partnership is treated as transferring consideration to the partner only to the extent provided in paragraph (a)(5) of this section. By contrast, if the partnership assumes or takes property subject to a liability of the partner other than a qualified liability, the partnership is treated as transferring consideration to the partner to the extent that the amount of the liability exceeds the partner's share of that liability immediately after the partnership assumes or takes subject to the liability as provided in paragraphs (a) (2), (3) and (4) of this section.

(2) *Partner's share of liability.* A partner's share of any liability of the partnership is determined under the following rules:

(i) *Recourse liability.* A partner's share of a recourse liability of the partnership equals the partner's share of the liability under the rules of section 752 and the regulations thereunder. A partnership liability is a recourse liability to the extent that the obligation is a recourse liability under § 1.752–1(a)(1) or would be treated as a recourse liability under that section if it were treated as a partnership liability for purposes of that section.

(ii) *Nonrecourse liability.* A partner's share of a nonrecourse liability of the partnership is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under § 1.752–3(a)(3). A partnership liability is a nonrecourse liability of the partnership to the extent that the obligation is a nonrecourse liability under § 1.752–1(a)(2) or would be a nonrecourse liability of the partnership under § 1.752–1(a)(2) if it were treated as a partnership liability for purposes of that section.

(3) *Reduction of partner's share of liability.* For purposes of this section, a partner's share of a liability, immediately after a partnership assumes or takes subject to the liability, is determined by taking into account a subsequent reduction in the partner's share if—

(i) At the time that the partnership assumes or takes subject to a liability, it is anticipated that the transferring partner's share of the liability will be subsequently reduced; and

(ii) The reduction of the partner's share of the liability is part of a plan that has as one of its principal purposes minimizing the extent to which the assumption of or taking subject to the liability is treated as part of a sale under § 1.707–3.

(4) *Special rule applicable to transfers of encumbered property to a partnership by more than one partner pursuant to a plan.* For purposes of paragraph (a)(1) of this section, if the partnership assumes or takes property or properties subject to the liabilities of more than one partner pursuant to a plan, a partner's share of the liabilities assumed or taken subject to by the partnership pursuant to that plan immediately after the transfers equals the sum of that partner's shares of the liabilities (other than that partner's qualified liabilities, as defined in paragraph (a)(6) of this section) assumed or taken subject to by the partnership pursuant to the plan. This paragraph (a)(4) does not apply to any liability assumed or taken subject to by the partnership with a principal purpose of reducing the extent to which any other liability assumed or taken subject to by the partnership is treated as a transfer of consideration under paragraph (a)(1) of this section.

(5) *Special rule applicable to qualified liabilities.* (i) If a transfer of property by a partner to a partnership is not otherwise treated as part of a sale, the partnership's assumption of or taking subject to a qualified liability in connection with a transfer of property is not treated as part of a sale. If a transfer of property by a partner to the partnership is treated as part of a sale without regard to the partnership's assumption of or taking subject to a qualified liability (as defined in paragraph (a)(6) of this section) in connection with the transfer of property, the partnership's assumption of or taking subject to that

liability is treated as a transfer of consideration made pursuant to a sale of such property to the partnership only to the extent of the lesser of—

(A) The amount of consideration that the partnership would be treated as transferring to the partner under paragraph (a)(1) of this section if the liability were not a qualified liability; or

(B) The amount obtained by multiplying the amount of the qualified liability by the partner's net equity percentage with respect to that property.

(ii) A partner's net equity percentage with respect to an item of property equals the percentage determined by dividing—

(A) The aggregate transfers of money or other consideration to the partner by the partnership (other than any transfer described in this paragraph (a)(5)) that are treated as proceeds realized from the sale of the transferred property; by

(B) The excess of the fair market value of the property at the time it is transferred to the partnership over any qualified liability encumbering the property or, in the case of any qualified liability described in paragraph (a)(6)(i)(C) or (D) of this section, that is properly allocable to the property.

(6) *Qualified liability of a partner defined.* A liability assumed or taken subject to by a partnership in connection with a transfer of property to the partnership by a partner is qualified liability of the partner only to the extend—

(i) The liability is—

(A) A liability that was incurred by the partner more than two years prior to the earlier of the date the partner agrees in writing to transfers the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property throughout that two-year period;

(B) A liability that was not incurred in anticipation of the transfer of the property to a partnership, buy that was incurred by the partner within the two-year period prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property since it was incurred (see paragraph (a)(7) of this section for further rules regarding a liability incurred within two years of a property transfer or of a written agreement to transfer);

(C) A liability that is allocable under the rules of §1.163–8T to capital expenditures with respect to the property; or

(D) A liability that was incurred in the ordinary course of the trade or business in which property transferred to the partnership was used or held but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business; and

(ii) If the liability is a recourse liability, the amount of the liability does not exceed the fair market value of the transferred property (less the amount of any other liabilities that are senior in priority and that either encumber such property or are liabilities described in paragraph (a)(6)(i) (C) or (D) of this section) at the time of the transfer.

(7) *Liability incurred within two years of transfer presumed to be in anticipation of the transfer*—(i) *In general.* For purposes of this section, if within a two-year period a partner incurs a liability (other than a liability described in paragraph (a)(6)(i) (C) or (D) of this section) and transfers property to a partnership or agrees in writing to transfer the property, and in connection with the transfer the partnership assumes or takes the property subject to the liability, the liability is presumed to be incurred in anticipation of the transfer unless the facts and circumstances clearly establish that the liability was not incurred in anticipation of the transfer.

(ii) *Disclosure of transfers of property subject to liabilities incurred within two years of the transfer.* If a partner treats a liability assumed or taken subject to by a partnership as a qualified liability under paragraph (a)(6)(i)(B) of this section, such treatment is to be disclosed to the Internal Revenue Service in accordance with §1.707–8.

(b) *Treatment of debt-financed transfers of consideration by partnerships*—(1) *In general.* For purposes of §1.707–3, if a partner transfers property to a partnership, and the partnership incurs a

liability and all or a portion of the proceeds of that liability are allocable under §1.163–8T to a transfer of money or other consideration to the partner made within 90 days of incurring the liability, the transfer of money or other consideration to the partner is taken into account only to the extent that the amount of money or the fair market value of the other consideration transferred exceeds that partner's allocable share of the partnership liability.

(2) *Partner's allocable share of liability*—(i) *In general.* A partner's allocable share of a partnership liability for purposes of paragraph (b)(1) of this section equals the amount obtained by multiplying the partner's share of the liability as described in paragraph (a)(2) of this section by the fraction determined by dividing—

(A) The portion of the liability that is allocable under §1.163–8T to the money or other property transferred to the partner; by

(B) The total amount of the liability.

(ii) *Debt-financed transfers made pursuant to a plan*—(A) *In general.* Except as provided in paragraph (b)(2)(iii) of this section, if a partnership transfers to more than one partner pursuant to a plan all or a portion of the proceeds of one or more partnership liabilities, paragraph (b)(1) of this section is applied by treating all of the liabilities incurred pursuant to the plan as one liability, and each partner's allocable share of those liabilities equals the amount obtained by multiplying the sum of the partner's shares of each of the respective liabilities (as defined in paragraph (a)(2) of this section) by the fraction obtained by dividing—

(*1*) The portion of those liabilities that is allocable under §1.163–8T to the money or other consideration transferred to the partners pursuant to the plan; by

(*2*) The total amount of those liabilities.

(B) *Special rule.* Paragraph (b)(2)(ii)(A) of this section does not apply to any transfer of money or other property to a partner that is made with a principal purpose of reducing the extent to which any transfer is taken into account under paragraph (b)(1) of this section.

(iii) *Reduction of partner's share of liability.* For purposes of paragraph (b)(2) of this section, a partner's share of a liability, immediately after the partnership assumes or takes subject to the liability, is determined by taking into account a subsequent reduction in the partner's share if—

(A) It is anticipated that the partner's share of the liability that is allocable to a transfer of money or other consideration to the partner will be reduced subsequent to the transfer; and

(B) The reduction of the partner's share of the liability is part of a plan that has as one of its principal purposes minimizing the extent to which the partnership's distribution of the proceeds of the borrowing is treated as part of a sale.

(c) *Refinancings.* To the extent that the proceeds of a partner or partnership liability (the *refinancing debt*) are allocable under the rules of §1.163–8T to payments discharging all or part of any other liability of that partner or of the partnership, as the case may be, the refinancing debt is treated as the other liability for purposes of applying the rules of this section.

(d) *Share of liability where assumption accompanied by transfer of money.* For purposes of §§1.707–3 through 1.707–5, if pursuant to a plan a partner pays or contributes money to the partnership and the partnership assumes or takes subject to one or more liabilities (other than qualified liabilities) of the partner, the amount of those liabilities that the partnership is treated as assuming or taking subject to is reduced (but not below zero) by the money transferred.

(e) *Tiered partnerships and other related persons.* If a lower-tier partnership succeeds to a liability of an upper-tier partnership, the liability in the lower-tier partnership retains the characterization as qualified or nonqualified that it had under these rules in the upper-tier partnership. A similar rule applies to other related party transactions involving liabilities to the extent provided by guidance published in the Internal Revenue Bulletin.

(f) *Examples.* The following examples illustrate the application of this section.

Example 1. Partnership's assumption of nonrecourse liability encumbering transferred property. (i) A and B form partnership AB, which will engage in renting office space. A transfers $500,000 in cash to the partnership, and B transfers an office building to the partnership. At the time it is transferred to the partnership, the office building has a fair market value of $1,000,000, an adjusted basis of $400,000, and is encumbered by a $500,000 liability, which B incurred 12 months earlier to finance the acquisition of other property. No facts rebut the presumption that the liability was incurred in anticipation of the transfer of the property to the partnership. Assume that this liability is a nonrecourse liability of the partnership within the meaning of section 752 and the regulations thereunder. The partnership agreement provides that partnership items will be allocated equally between A and B, including excess nonrecourse deductions under §1.752–3(a)(3). The partnership agreement complies with the requirements of §1.704–1(b)(2)(ii)(*b*).

(ii) The nonrecourse liability secured by the office building is not a qualified liability within the meaning of paragraph (a)(6) of this section. B would be allocated 50 percent of the excess nonrecourse liability under the partnership agreement. Accordingly, immediately after the partnership's assumption of that liability, B's share of the liability equals $250,000, which is equal to B's 50 percent share of the excess nonrecourse liability of the partnership as determined in accordance with B's share of partnership profits under §1.752–3(a)(3).

(iii) The partnership's taking subject to the liability encumbering the office building is treated as a transfer of $250,000 of consideration to B (the amount by which the liability ($500,000) exceeds B's share of that liability immediately after taking subject to $250,000)). B is treated as having sold $250,000 of the fair market value of the office building to the partnership in exchange for the partnership's taking subject to a $250,000 liability. This results in a gain of $150,000 ($250,000 minus ($250,000/$1,000,000 multiplied by $400,000)).

Example 2. Partnership's assumption of recourse liability encumbering transferred property. (i) C transfers property Y to a partnership. At the time of its transfer to the partnership, property Y has a fair market value of $10,000,000 and is subject to an $8,000,000 liability that C incurred, immediately before transferring property Y to the partnership, in order to finance other expenditures. Upon the transfer of property Y to the partnership, the partnership assumed the liability encumbering that property. The partnership assumed this liability solely to acquire property Y. Under section 752 and the regulations thereunder, immediately after the partnership's assumption of the liability encumbering property Y, the liability is a recourse liability of the partnership and C's share of that liability is $7,000,000.

(ii) Under the facts of this example, the liability encumbering property Y is not a qualified liability.

Accordingly, the partnership's assumption of the liability results in a transfer of consideration to C in connection with C's transfer of property Y to the partnership in the amount of $1,000,000 (the excess of the liability assumed by the partnership ($8,000,000) over C's share of the liability immediately after the assumption ($7,000,000)). See paragraphs (a) (1) and (2) of this section.

Example 3. Subsequent reduction of transferring partner's share of liability. (i) The facts are the same as in Example 2. In addition, property Y is a fully leased office building, the rental income from property Y is sufficient to meet debt service, and the remaining term of the liability is ten years. It is anticipated that, three years after the partnership's assumption of the liability, C's share of the liability under section 752 will be reduced to zero because of a shift in the allocation of partnership losses pursuant to the terms of the partnership agreement. Under the partnership agreement, this shift in the allocation of partnership losses is dependent solely on the passage of time.

(ii) Under paragraph (a)(3) of this section, if the reduction in C's share of the liability was anticipated at the time of C's transfer, and the reduction was part of a plan that has as one of its principal purposes minimizing the extent of sale treatment under §1.707–3 (*i.e.,* a principal purpose of allocating a large percentage of losses to C in the first three years when losses were not likely to be realized was to minimize the extent to which C's transfer would be treated as part of a sale), C's share of the liability immediately after the assumption is treated as equal to C's reduced share.

Example 4. Trade payables as qualified liabilities. (i) D and E form partnership DE which will engage in a consulting business that requires no overhead and minimal cash on hand for daily operating expenses. Previously, D and E, as individual sole proprietors, operated separate consulting businesses. D and E each transfer to the partnership sufficient cash to cover daily operating expenses together with the goodwill and trade payables related to each sole proprietorship. Due to uncertainty over the collection rate on the trade receivables related to their sole proprietorships, D and E agree that none of the trade receivables will be transferred to the partnership.

(ii) Under the facts of this example, all the assets related to the consulting business (other than the trade receivables) together with the trade payables were transferred to partnership DE. The trade receivables retained by D and E are not material to a continuation of the trade or business by the

partnership because D and E contributed sufficient cash to cover daily operating expenses. Accordingly, the trade payables transferred to the partnership constitute qualified liability under paragraph (a)(6) of this section.

Example 5. Partnership's assumption of a qualified liability as sole consideration. (i) F transfers property Z to a partnership. At the time of its transfer to the partnership, property Z has a fair market value of $165,000 and an adjusted tax basis of $75,000. Also, at the time of the transfer, property Z is subject to a $75,000 liability that F incurred more than two years before transferring property Z to the partnership. The liability has been secured by property Z since it was incurred by F. Upon the transfer of property Z to the partnership, the partnership assumed the liability encumbering that property. The partnership made no other transfers to F in consideration for the transfer of property Z to the partnership. Assume that, under section 752 and the regulations thereunder, immediately after the partnership's assumption of the liability encumbering property Z, the liability is a recourse liability of the partnership and F's share of that liability is $25,000.

(ii) The $75,000 liability secured by property Z is a qualified liability of F because F incurred the liability more than two years prior to the assumption of the liability by the partnership and the liability has encumbered property Z for more than two years prior to that assumption. *See* paragraph (a)(6) of this section. Therefore, since no other transfer to F was made as consideration for the transfer of property Z, under paragraph (a)(5) of this section, the partnership's assumption of the qualified liability of F encumbering property Z is not treated as part of a sale.

Example 6. Partnership's assumption of a qualified liability in addition to other consideration. (i) The facts are the same as in *Example 5,* except that the partnership makes a transfer to D of $30,000 in money that is consideration for F's transfer of property Z to the partnership under § 1.707–3.

(ii) As in *Example 5,* the $75,000 liability secured by property Z is a qualified liability of F. Since the partnership transferred $30,000 to F in addition to assuming the qualified liability under paragraph (a)(5) of this section, the partnership's assumption of this qualified liability is treated as a transfer of additional consideration to F to the extent of the lesser of—

(A) The amount that the partnership would be treated as transferring to F if the liability were not a qualified liability ($50,000 (*i.e.,* the excess of the $75,000 qualified liability over F's $25,000 share of that liability)); or

(B) The amount obtained by multiplying the qualified liability ($75,000) by F's net equity percentage with respect to property Z (one-third).

(iii) F's net equity percentage with respect to property Z equals the fraction determined by dividing—

(A) The aggregate amount of money or other consideration (other than the qualified liability) transferred to F and treated as part of a sale of property Z under § 1.707–3(a) ($30,000 transfer of money); by

(B) F's net equity in property Z ($90,000 (*i.e.,* the excess of the $165,000 fair market value over the $75,000 qualified liability)).

(iv) Accordingly, the partnership's assumption of the qualified liability of F encumbering property Z is treated as a transfer of $25,000 (one-third of $75,000) of consideration to F pursuant to a sale. Therefore, F is treated as having sold $55,000 of the fair market value of property Z to the partnership in exchange for $30,000 in money and the partnership's assumption of $25,000 of the qualified liability. Accordingly, F must recognize $30,000 of gain on the sale (the excess of the $55,000 amount realized over $25,000 of F's adjusted basis for property, Z (i.e., one-third of F's adjusted basis for the property, because F is treated as having sold one-third of the property to the partnership)).

Example 7. Partnership's assumptions of liabilities encumbering properties transferred pursuant to a plan. (i) Pursuant to a plan, G and H transfer property 1 and property 2, respectively, to an existing partnership in exchange for interests in the partnership. At the time the properties are transferred to the partnership, property 1 has a fair market value of $10,000 and an adjusted tax basis of $6,000, and property 2 has a fair market value of $10,000 and an adjusted tax basis of $4,000. At the time properties 1 and 2 are transferred to the partnership, a $6,000 nonrecourse liability (*liability 1*) is secured by property 1 and a $7,000 recourse liability of F (*liability 2*) is secured by property 2. Properties 1 and 2 are transferred to the partnership, and the partnership takes subject to liability 1 and assumes liability 2. G and H incurred liabilities 1 and 2 immediately prior to transferring properties 1 and 2 to the partnership and used the proceeds for personal expenditures. The liabilities are not qualified liabilities. Assume that G and H are each allocated $2,000 of liability 1 in accordance with § 1.707–5(a)(2)(ii) (which determines a partner's share of a nonrecourse liability). Assume further that G's share of liability 2 is $3,500 and H's share is $0 in accordance with § 1.707–5(a)(2)(i) (which determines a partner's share of a recourse liability).

(ii) G and H transferred properties 1 and 2 to the partnership pursuant to a plan. Accordingly, the partnership's taking subject to liability 1 is treated as a transfer of only $500 of consideration to G, (the amount by which liability 1 ($6,000) exceeds G's share of liabilities 1 and 2 ($5,500)), and the partnership's assumption of liability 2 is treated as a transfer of only $5,000 of consideration to H

(the amount by which liability 2 ($7,000) exceeds H's share of liabilities 1 and 2 ($2,000)). G is treated under the rule in §1.707–3 as having sold $500 of the fair market value of property 1 in exchange for the partnership's taking subject to liability 1 and H is treated as having sold $5,000 of the fair market value of property 2 in exchange for the assumption of liability 2.

Example 8. Partnership's assumption of liability pursuant to a plan to avoid sale treatment of partnership assumption of another liability. (i) The facts are the same as in *Example 7,* except that—

(A) H transferred the proceeds of liability 2 to the partnership; and

(B) H incurred liability 2 in an attempt to reduce the extent to which the partnership's taking subject to liability 1 would be treated as a transfer of consideration to G (and thereby reduce the portion of G's transfer of property 1 to the partnership that would be treated as part of a sale).

(ii) Because the partnership assumed liability 2 with a principal purpose of reducing the extent to which the partnership's taking subject to liability 1 would be treated as a transfer of consideration to G, liability 2 is ignored in applying paragraph (a)(3) of this section. Accordingly, the partnership's taking subject to liability 1 is treated as a transfer of $4,000 of consideration to G (the amount by which liability 1 ($6,000) exceeds G's share of liability 1 ($2,000)). On the other hand, the partnership's assumption of liability 2 is not treated as a transfer of any consideration to H because H's share of that liability equals $7,000 as a result of H's transfer of $7,000 in money to the partnership.

Example 9. Partnership's assumptions of qualified liabilities encumbering properties transferred pursuant to a plan in addition to other consideration. (i) Pursuant to a plan, I transfers property 1 and J transfers property 2 plus $10,000 in cash to partnership IJ in exchange for equal interests in the partnership. At the time the properties are transferred to the partnership, property 1 has a fair market value of $100,000, an adjusted tax basis of $5,000, and is encumbered by a qualified liability of $50,000 (*liability 1).* Property 2 has a fair market value of $100,000, an adjusted tax basis of $5,000, and is encumbered by a qualified liability of $70,000 (*liability 2).* Pursuant to the plan, the partnership transferred to I $10,000 in cash. That amount is consideration for I's transfer of property 1 to the partnership under §1.707–3. In accordance with §1.707–5(a)(2), I and J are each allocated $25,000 of liability 1 and $35,000 of liability 2.

(ii) Because the partnership transferred $10,000 to I as consideration for the transfer of property, under §1.707–5(a)(5), the partnership's assumption of liability 1 is treated as a transfer of additional consideration to I, even though liability 1 is a qualified liability, to the extent of the lesser of—

(A) The amount that the partnership would be treated as transferring to I if the liability were not a qualified liability; or

(B) The amount obtained by multiplying the qualified liability by I's net equity percentage with respect to property 1.

(iii) Because I and J transferred properties 1 and 2 to the partnership pursuant to a plan, treating I's qualified liability as a nonqualified liability under §1.707–5(a)(5)(i)(A) enables I to apply the special rule applicable to transfers of encumbered property to a partnership by more than one partner pursuant to a plan under §1.707–5(a)(4). Under this alternative test, the partnership's assumption of liability 1 encumbering property 1 is treated as a transfer of zero ($0) additional consideration to I pursuant to a sale. This is because the amount of liability 1 ($50,000) does not exceed the sum of I's share of liability 1 treated as a nonqualified liability ($25,000) and I's share of liability 2 ($35,000)).

(iv) The alternative under §1.707–5(a)(5)(i)(B) is the amount obtained by multiplying the qualified liability ($50,000) by I's net equity percentage with respect to property 1. I's net equity percentage with respect to property 1 equals one-fifth, the fraction determined by dividing—

(A) The aggregate amount of money or other consideration (other than the qualified liability) transferred to I and treated as part of a sale of property 1 under §1.707–3(a) (the $10,000 transfer of money; by

(B) I's net equity in property 1 ($50,000 *i.e.*, the excess of the $100,000 fair market value over the $50,000 qualified liability).

(v) Under this alternative test, the partnership's assumption of the qualified liability encumbering property 1 is treated as a transfer of $10,000 (one-fifth of the $50,000 qualified liability) of additional consideration to I pursuant to a sale.

(vi) Applying §1.707–5(a)(5) to these facts, the partnership's assumption of liability 1 is treated as a transfer of additional consideration to I to the extent of the lesser of—

(A) zero; or

(B) $10,000.

(vii) Therefore, the partnership's assumption of I's qualified liability encumbering property 1 is not treated as a transfer of any additional consideration to I pursuant to a sale, and I is treated as having only received $10,000 of the fair market value of property 1 to the partnership in exchange for $10,000 in cash. Accordingly, I must recognize $9,500 of gain on the sale, that is, the excess of the $10,000 amount realized over $500 of I's adjusted tax basis for property 1 (one-tenth of I's adjusted tax basis for the property, because I is treated as having sold one-tenth of the property to the partnership). Since no

other transfer to J was made as consideration for the transfer of property 2, the partnership's assumption of the qualified liability of J encumbering property 2 is not treated as part of a sale.

Example 10. Treatment of debt-financed transfers of consideration by partnership. (i) K transfers property Z to partnership KL in exchange for an interest therein on April 9, 1992. On September 13, 1992, the partnership incurs a liability of $20,000. On November 17, 1992, the partnership transfers $20,000 to K, and $10,000 of this transfer is allocable under the rules of §1.163–8T to proceeds of the partnership liability incurred on September 13, 1992. The remaining $10,000 is paid from other partnership funds. Assume that, under section 752 and the corresponding regulations, the $20,000 liability incurred on September 13, 1992, is a recourse liability of the partnership and K's share of that liability is $10,000 on November 17, 1992.

(ii) Because a portion of the transfer made to K on November 17, 1992, is allocable under §1.163–8T to proceeds of a partnership liability that was incurred by the partnership within 90 days of that transfer, K is required to take the transfer into account in applying the rules of this section and §1.707–3 only to the extent that the amount of the transfer exceeds K's allocable share of the liability used to fund the transfer. K's allocable share of the $20,000 liability used to fund $10,000 of the transfer to K is $5,000 (K's share of the liability ($10,000) multiplied by the fraction obtained by dividing—

(A) The amount of the liability that is allocable to the distribution to K ($10,000); by

(B) The total amount of such liability ($20,000)).

(iii) Therefore, K is required to take into account only $15,000 of the $20,000 partnership transfer to K for purposes of this section and §1.707–3. Under these facts, assuming the within-two-year presumption is not rebutted, this $15,000 transfer will be treated under the rule in §1.707–3 as part of a sale by K of property Z to the partnership.

Example 11. Borrowing against pool of receivables. (i) M generates receivables which have an adjusted basis of zero in the ordinary course of its business. For M to use receivables as security for a loan, a commercial lender requires M to transfer the receivables to a partnership in which M has a 90 percent interest. In January, 1992, M transfers to the partnership receivables with a face value of $100,000. N (who is not related to M) transfers $10,000 cash to the partnership in exchange for a 10 percent interest. The partnership borrows $80,000, secured by the receivables, and makes a distribution of $72,000 of the proceeds to M and $8,000 of the proceeds to N within 90 days of incurring the liability. M's share of the liability under §1.707–5(a)(2) is $72,000 (90 percent × $80,000).

(ii) Because the transfer of the loan proceeds to M is allocable under §1.163–8T to proceeds of a partnership loan that was incurred by the partnership within 90 days of that transfer, M is required to take the transfer into account in applying the rules of this section and §1.707–3 only to the extent that the amount of the transfer ($72,000) exceeds M's allocable share of the liability used to fund the transfer. Because the distribution was a debt-financed transfer pursuant to a plan, M's allocable share of the liability is $72,000 ($72,000 × $80,000/80,000) under §1.707–5(b)(2)(ii). Therefore, M is not required to take into account any of the loan proceeds for purposes of this section and §1.707–3.

(iii) When the receivables are collected, M must be allocated the gain on the contributed receivables under section 704(c). However, the lender permits the partnership to distribute cash to the partners only to the extent of the value of new receivables contributed to the partnership. In 1993, M contributes additional receivables and receives a distribution of cash. The taxable income recognized by the partnership on the receivables is taxable income of the partnership arising in the ordinary course of the partnership's activities. To the extent the distribution does not exceed 90 percent (M's percentage interest in overall partnership profits) of the partnership's operating cash flow under §1.707–4(b), the distribution to M is presumed not to be a part of a sale of receivables by M to the partnership, and the presumption is not rebutted under these facts.

[T.D. 8439, 57 FR 44983, Sept. 30, 1992]

§1.707–6 Disguised sales of property by partnership to partner; general rules.

(a) *In general.* Rules similar to those provided in §1.707–3 apply in determining whether a transfer of property by a partnership to a partner and one or more transfers of money or other consideration by that partner to the partnership are treated as a sale of property, in whole or in part, to the partner.

(b) *Special rules relating to liabilities*—(1) *In general.* Rules similar to those provided in §1.707–5 apply to determine the extent to which an assumption of or taking subject to a liability by a partner, in connection with a transfer of property by a partnership, is considered part of a sale. Accordingly, if a partner assumes or takes property subject to a qualified liability (as defined in paragraph (b)(2) of this section) of a partnership, the partner is treated as

transferring consideration to the partnership only to the extent provided in paragraph (b). If the partner assumes or takes subject to a liability that is not a qualified liability, the amount treated as consideration transferred to the partnership is the amount that the liability assumed or taken subject to by the partner exceeds the partner's share of that liability (determined under the rules of §1.707–5(a)(2)) immediately before the transfer. Similar to the rules provided in §1.707–5(a)(4), if more than one partner assumes or takes subject to a liability pursuant to a plan, the amount that is treated as a transfer of consideration by each partner is the amount by which all of the liabilities (other than qualified liabilities) assumed or taken subject to by the partner pursuant to the plan exceed the partner's share of all of those liabilities immediately before the assumption or taking subject to. This paragraph (b)(1) does not apply to any liability assumed or taken subject to by a partner with a principal purpose of reducing the extent to which any other liability assumed or taken subject to by a partner is treated as a transfer of consideration under this paragraph (b).

(2) *Qualified liabilities.* (i) If a transfer of property by a partnership to a partner is not otherwise treated as part of a sale, the partner's assumption of or taking subject to a qualified liability is not treated as part of a sale. If a transfer of property by a partnership to the partner is treated as part of a sale without regard to the partner's assumption of or taking subject to a qualified liability, the partner's assumption of or taking subject to that liability is treated as a transfer of consideration made pursuant to a sale of such property to the partner only to the extent of the lesser of—

(A) The amount of consideration that the partner would be treated as transferring to the partnership under paragraph (b) of this section if the liability were not a qualified liability; or

(B) The amount obtained by multiplying the amount of the liability at the time of its assumption or taking subject to by the partnership's net equity percentage with respect to that property.

(ii) A partnership's net equity percentage with respect to an item of property encumbered by a qualified liability equals the percentage determined by dividing—

(A) The aggregate transfers to the partnership from the partner (other than any transfer described in this paragraph (b)(2)) that are treated as the proceeds realized from the sale of the transferred property to the partner; by

(B) The excess of the fair market value of the property at the time it is transferred to the partner over any qualified liabilities of the partnership that are assumed or taken subject to by the partner at that time.

(iii) For purposes of this section, the definition of a qualified liability is that provided in §1.707–5(a)(6) with the following exceptions—

(A) In applying the definition, the qualified liability is one that is originally an obligation of the partnership and is assumed or taken subject to by the partner in connection with a transfer of property to the partner; and

(B) If the liability was incurred by the partnership more than two years prior to the earlier of the date the partnership agrees in writing to transfer the property or the date the partnership transfers the property to the partner, that liability is a qualified liability whether or not it has encumbered the transferred property throughout the two-year period.

(c) *Disclosure rules.* Similar to the rules provided in §§1.707–3(c)(2) and 1.707–5(a)(7)(ii), a partnership is to disclose to the Internal Revenue Service, in accordance with §1.707–8, the facts in the following circumstances:

(1) When a partnership transfers property to a partner and the partner transfers money or other consideration to the partnership within a two-year period (without regard to the order of the transfers) and the partnership treats the transfers as other than a sale for tax purposes; and

(2) When a partner assumes or takes subject to a liability of a partnership in connection with a transfer of property by the partnership to the partner, and the partnership incurred the liability within the two-year period prior to the earlier of the date the partnership

agrees in writing to the transfer of property or the date the partnership transfers the property, and the partnership treats the liability as a qualified liability under rules similar to § 1.707–5(a)(6)(i)(B).

(d) *Examples.* The following examples illustrate the rules of this section.

Example 1. Sale of property by partnership to partner. (i) A is a member of a partnership. The partnership transfers property X to A. At the time of the transfer, property X has a fair market value of $1,000,000. One year after the transfer, A transfers $1,100,000 to the partnership. Assume that under the rules of section 1274 the imputed principal amount of an obligation to transfer $1,100,000 one year after the transfer of property X is $1,000,000 on the date of the transfer.

(ii) Since the transfer of $1,100,000 to the partnership by A is made within two years of the transfer of property X to A, under rules similar to those provided in § 1.707–3(c), the transfers are presumed to be a sale unless the facts and circumstances clearly establish otherwise. If no facts exist that would rebut this presumption, on the date that the partnership transfers property X to A, the partnership is treated as having sold property X to A in exchange for A's obligation to transfer $1,100,000 to the partnership one year later.

Example 2. Assumption of liability by partner. (i) B is a member of an existing partnership. The partnership transfers property Y to B. On the date of the transfer, property Y has a fair market value of $1,000,000 and is encumbered by a nonrecourse liability of $600,000. B takes the property subject to the liability. The partnership incurred the nonrecourse liability six months prior to the transfer of property Y to B and used the proceeds to purchase an unrelated asset. Assume that, under rule of § 1.707–5(a)(2)(ii) (which determines a partner's share of a nonrecourse liability), B's share of the nonrecourse liability immediately before the transfer of property Y was $100,000.

(ii) The liability is not allocable under the rules of § 1.163–8T to capital expenditures with respect to the property transferred to B and was not incurred in the ordinary course of the trade or business in which the property transferred to the partner was used or held. Since the partnership incurred the nonrecourse liability within two years of the transfer to B, under rules similar to those provided in § 1.707–5(a)(5), the liability is presumed to be incurred in anticipation of the transfer unless the facts and circumstances clearly establish the contrary. Assuming no facts exist to rebut this presumption, the liability taken subject to by B is not a qualified liability. The partnership is treated as having received, on the date of the transfer of property Y to B, $500,000 ($600,000 liability assumed by B less B's share of the $100,000 liability immediately prior to the transfer) as consideration for the sale of one-half ($500,000/$1,000,000) of property Y to B. The partnership is also treated as having distributed to B, in B's capacity as a partner, the other one-half of property Y.

[T.D. 8439, 57 FR 44987, Sept. 30, 1992]

§ 1.707–7 Disguised sales of partnership interests. [Reserved]

§ 1.707–8 Disclosure of certain information.

(a) *In general.* The disclosure referred to in § 1.707–3(c)(2) (regarding certain transfers made within two years of each other), § 1.707–5(a)(7)(ii) (regarding a liability incurred within two years prior to a transfer of property), and § 1.707–6(c) (relating to transfers of property from a partnership to a partner in situations analogous to those listed above) is to be made in accordance with paragraph (b) of this section.

(b) *Method of providing disclosure.* Disclosure is to be made on a completed Form 8275 or on a statement attached to the return of the transferor of property for the taxable year of the transfer that includes the following:

(1) A caption identifying the statement as disclosure under section 707;

(2) An identification of the item (or group of items) with respect to which disclosure is made;

(3) The amount of each item; and

(4) The facts affecting the potential tax treatment of the item (or items) under section 707.

(c) *Disclosure by certain partnerships.* If more than one partner transfers property to a partnership pursuant to a plan, the disclosure required by this section may be made by the partnership on behalf of all the transferors rather than by each transferor separately.

[T.D. 8439, 57 FR 44988, Sept. 30, 1992]

§ 1.707–9 Effective dates and transitional rules.

(a) *Sections 1.707–3 through 1.707–6*—(1) *In general.* Except as provided in paragraph (a)(3) of this section, §§ 1.707–3 through 1.707–6 apply to any transaction with respect to which all transfers that are part of a sale of an item of property occur after April 24, 1991.